Whiteside & Associates

Memo

From: Terry Whiteside

To: Montana Wheat & Barley Committee

Date: July 2, 2008

Re: Transportation Report

STB ISSUES FIRST DECISION IN NEW 'SIMPLIFIED' SMALL RATE CASES – A VICTORY FOR CAPTIVE SHIPPERS

The decisions came in the DuPont company small rate case challenges of CSX rates on chemicals (3 cases involving 7 movements) STB Docket No. 42099, 42100 and 42101 and they are victories for DuPont. The decisions are the first under the newly adopted "Small Rate Case" doctrine promulgated by the STB last fall.

In 2007, the Surface Transportation Board (STB), after several years of study and pressure from Congress to balance the pendulum of decisions more in favor of shippers, issued new small rate case rules.

The Ex Parte proceeding (EP 646 Sub No. 1) leading up to the new rules was a lengthy process. The Montana Wheat & Barley Committee, Governor Schweitzer together with the Montana Farm groups provided a great deal of input into the 'new' rules process represented by Whiteside & Associates.

While the new rules didn't turn out perfect – and they are being appealed to Appellate Court in DC by the shippers, they are rules that captive rail shippers must rely on until they are changed by the STB or the courts.

The railroads showed their true colors in the original Ex Parte proceeding leading up to the formulation of the new rules, when they fought vigorously against the implementation of the new rules – and one of their key arguments (which the STB rejected) was that large shippers should not be allowed to file small rate cases. Additionally, a number of Class I railroads told the STB that to allow more rate challenges by utilizing this simplified process would impede their ability to provide needed infrastructure investment. In fact,

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the railroads did not embrace the concept of increasing the ability of rail customers having greater access to challenging rates – even though the proceedings were initiated because of calls by Congress of the perception of railroad bias in STB rate challenge rulings.

The Surface Transportation Board said in its decision, that CSX Transportation is charging "unreasonably high" rates to chemical shipper E.I. du Pont de Nemours, and ordered the railroad to both cut its charges on the specified shipments and pay DuPont reparations. The decision came in three related cases filed by the shipper, each of which carries a limit of up to $1 million in reparations and rate relief or up to $3 million in all over five years. DuPont challenged rates on seven routes, and won relief on six of them.

The actual amount of money DuPont can recover will depend on the number of shipments made along the routes where it challenged the CSX rates, but the STB said reductions will range from 5 to 40 percent of the challenged rates.

This was the first real test of the STB's revamped "small rate" case rules, under which it slashed fees and other expenses for shippers to challenge rail rates. STB Chairman Charles D. Nottingham has cited those and other changes the board has been making to show it can treat shipper complaints fairly without Congress ordering it to regulate railroads more forcefully.

Some observers feel that the STB feeling the pressure by Congress to do 'something positive' for the shippers.

Chairman Nottingham said in the order, the unanimous decisions on the DuPont rate cases "demonstrate the board's dedication to resolving disputes between railroads and their customers in an accessible, affordable, and expeditious manner. Freight-rail customers can rest assured that the board will take effective action to strike down unreasonably high rail rates."

John Cutler and Andy Goldstein, with McCarthy, Sweeney and Harkaway in Washington DC commented that the Board's three DuPont decisions, issued late yesterday, provide useful guidance on the STB's Three Benchmark test and they having their cost consultants analyze the decisions.

What did the Board do?

1. **Probably most important is the fact that the Board ordered reductions in 6 of the 7 rates DuPont challenged in its three proceedings**.

Note that DuPont challenged CSX rates on chlorine in one case involving three different origin-destination pairs; challenged CSX rates on plastic powder and plasticizers in another case involving another three origin-destination pairs; and challenged CSX rates on nitrobenzene between a Mississippi origin and a North Carolina destination in the third case.

2. Market Dominance Issues

The one challenged rate as to which no relief was ordered involved chlorine shipments from Natrium, WV to New Johnsonville, TN. The Board rejected relief as to this movement because it found that DuPont had shipped 90% of the chlorine moving between these points by barge, with only 10% being transported in tank cars by CSX. The Board found no evidence that DuPont was captive as to that 10% (even though the R/VC ratios exceeded 180%), so it found no market dominance, without reaching the issue of the reasonableness of the CSX rate levels.

CSX attempted to argue that it lacked market dominance as to other movements based on claimed product and geographic competition, but the Board refused to consider those claims.

The Board also observed that market dominance may exist even where rail rates are similar to truck rates, saying "***the fact that the carrier matches prices set by alternatives with significantly higher costs, while maintaining a dominant market share, is not enough to demonstrate effective competition for the traffic at issue***." This statement is welcome because Commissioner Buttrey has made statements indicating that he doesn't believe a railroad has market dominance when it prices its service just below trucking rates, even though this results in very high railroad profit margins.

3. Rate Reasonableness

The Three Benchmark approach involves a formula analysis in which two benchmarks are published by the STB annually, and the third benchmark, based on a determination of the comparison group for the issue traffic, is the key focus of the parties' litigation efforts.

In the DuPont proceedings, the parties argued for modifications to the Board's approach but the Board brushed these aside as collateral attacks on its decision in Ex Parte No. 646 (Sub-No. 1), Simplified Standards in Rail Rate Cases.[1] The simplified rate case rules also allow parties to ask the Board to adjust the formula's results based on "other relevant factors," but the Board rejected those arguments too, basically applying its formula.

The three DuPont cases provide some guidance as to what types of other movements can be included in the comparison group. As expected, all other shipments must have R/VC ratios exceeding 180%.

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The mileages for DuPont's movements appear to have averaged about 700 miles. For its comparison group, DuPont rounded the mileage between the origin and destination in question to the nearest 50 miles, and then looked for comparable shipments and their rates moving that same distance, plus or minus 150 miles. For example, if DuPont's shipments moved 730 miles, DuPont rounded that to 750 miles, and looked for comparable shipments moving distances between 600 miles and 900 miles. This is a 20% plus or minus factor, which could mean a broader range for longer movements.

The commodities didn't need to be exactly the same, but need similar transportation characteristics. For example, CSX argued that the comparison group for DuPont's chlorine shipments should consist only of other chlorine shipments, and DuPont argued for inclusion of other TIH (toxic by inhalation) shipments. The Board agreed with DuPont, saying that chlorine and other TIH commodities have similar transportation characteristics.

DuPont argued for inclusion of other shipments with and without fuel surcharges, and CSX argued for using only other shipments with fuel surcharges in the comparison group. The Board sided with DuPont on the ground that CSX's approach could weight the comparison group too heavily with captive traffic, whose higher fuel surcharges cross-subsidize the fuel costs of less captive or non-captive shippers.

The R/VC ratios for the rates DuPont challenged appear to have been high -- generally well above 300%. However, the three Benchmark test awards relief based not on how high rates are in absolute terms, but on how high they are when compared with rate levels for other shipments using the formula.

For example, in the case involving shipments of chlorine, the Board found that the mean R/VC ratio for 28 movements in the comparison group for movements from Niagara Falls, NY to Johnsonville, TN, was 274%, and that the mean R/VC ratio for the 169 movements in the comparison group for movements from Niagara Falls to Carneys Point, NJ was 311%.

Applying its "confidence interval" (a fudge actor that favors the railroad) the Board concluded that the maximum reasonable rate for the NY to TN movement would have a 287% R/VC, and the maximum reasonable rate for the NY to NJ movements was 321% R/VC.

4. Relief

Under the Three Benchmark test, the maximum relief the Board will award is $1 million per case spread out over 5 years. The Board therefore ordered that CSX cannot charge more than the R/VC ratios it found as maximum reasonable levels for a period of 5 years as to the DuPont shipments at issue, or until DuPont has received $1 million in rate relief as to each rate case, whichever comes sooner. No new rate

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case can be filed as to these routings for 5 years, unless CSX publishes new higher rates. Part of this relief can take the form of reparations with interest, for prior payments going back 2 years that exceed maximum reasonable levels as found by the Board.

CSX argued that the potential relief should be spread out evenly over the 5 year period, because otherwise DuPont might collect $1 million in rate relief in a year or two and then rearrange its routings and file new rate cases as to the new routings. The Board rejected CSX's argument, but said that if DuPont rearranges its routings, CSX can argue that the Three Benchmark limit on relief will apply to the new routings.

.EDITORIAL:

This DuPont decision is important for the captive rail customers and congratulations go out to the DuPont folks who filed these test cases on some of their captive rail shipments to provide a pathway for others to follow. The adjudicated rates are still extremely high (300%) of variable (well over the 180% threshold of unreasonableness in other rate cases). But the significance of this decision is that the Board has admitted that there are captive rates that are too high and captive shippers can have some redress. The other key statement is that the STB has finally recognized that when the carrier is pricing just under an alternative mode of transport which has significantly higher cost structures – those high rail rates (captive shipper) cannot be utilized by the railroads to suggest there is effective competition. To suggest that railroads have effective competition from trucks to move 600 million bushels of wheat from the farm to market or 800 million tons of coal has always been a foolish argument put up by the railroads.

The U.S. railroads today are showing record profits all-the-while charging the highest freight rates in the country to their captive rail customers. Whole areas, whole states and even entire industries are captive to a single railroad and their monopoly pricing. Are these issues complicated? Sure, but **having captive rail customers subsidize the non- captive rail customers simply because they are captive is clearly not in the public interest and never has been.**

The railroads, for many years (since the Staggers Rail Act of 1980 to present), have cried to the STB (and Congress) that they haven't been able to make sufficient money and therefore should be given a free pass to charge 'what the traffic will bear' to captive rail customers to help with their revenues.

Those days are gone – that dog won't hunt anymore. With the record profits the railroads are showing; with the STB finally changing from its outmoded discounted counted cash flow cost of capital to the modern Capital Pricing Model (CAPM) cost of capital methodology; with the new small rate rules – a few of the goals of protecting captive rail shippers from monopoly abuse outlined 28 years ago in the Staggers Rail Act are starting to be addressed.

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Today, virtually all of the railroads are more than revenue adequate making more money than ever before in history and predictably the railroads are adopting a new cry – if Congress or STB change anything (including rule in favor of a small shipper on a rate case) – the railroads won't be able to meet their infrastructure needs in the future and America will suffer.

As Whiteside & Associates pointed out in its May 16th Transportation Report – in the section entitled: **IS THE RAIL CAPACITY SHORTAGE A STUDIED REALITY OR DOES IT CONTAIN SOME HYPE?** it is clear that these reports of impending doom and the sky is falling may be pragmatically and purposefully over-stating capacity shortages designed to scare the policy makers. As stated in the recent Final Report of the National Surface Transportation Policy and Revenue Study Commission established by Congress in the 2005 Highway Bill, SAFETEA-LU, and charged with assessing national infrastructure needs and options for meeting increased demand, including increased demand for freight transportation - that additional infrastructure funding is needed. However, when the Commission analyzed the railroad industry, its findings hardly supported a free hand for Railroads with respect to raising prices or rejecting service requests. On the contrary, the Commission found, based on AAR data, as follows:

> "**By contrast, the Nation's freight rail network is relatively uncongested at current volumes of cargo (see Exhibit 3-8). Eighty eight percent of today's primary freight rail corridor mileage is operating below practical capacity (Levels of Service (LOS) A/B/C). About 12 percent is near or at practical capacity (LOS D/E), and less than 1 percent is operating above capacity (LOS F).**"

Final Report at page 3-15.

And remember those findings pre-date the current economic slump, which has led to over-capacity for railroads and other carriers. While the AAR (American Association of Railroads) has argued, and the Commission found, that rail capacity constraints may exist in the future, the Final Report at 4-14 the Commission concluded that, by 2035, 54% of freight rail corridor mileage will be below or near capacity, 15% will be at capacity, and 30% will be above capacity. **It is important to note, however, that these figures assume no new capacity is added by the railroads in the next 28 years! Clearly the capacity crisis on the rail system is not equal to the magnitude of capacity constraints facing the other transportation modes.**

Do we need more investment in railroad infrastructure in the future in this country as well as road, highways, bridges, airports, waterways and streets? Sure but the railroads may be the least congested of the major transport systems right now. And they appear to be hyping the capacity shortage issue to foster political and economic gains in Washington DC both in Congress and at the Surface Transportation Board.

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